INDEX

311-976—68——1

Cases—Continued

United States Constitution, statutes and regulations: Page

United States Constitution, statutes and regulations—Con.

In the Supreme Court of the United States

OCTOBER TERM, 1968

No. 17

UNITED STATES OF AMERICA, PETITIONER

v.

THE DONRUSS COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE UNITED STATES

OPINIONS BELOW

The district court did not render an opinion. The opinion of the court of appeals (R. 50-60) is reported at 384 F. 2d 292.

JURISDICTION

The judgment of the court of appeals was entered on September 27, 1967 (R. 3, 61). The petition for a writ of certiorari was filed on December 26, 1967, and was granted on April 22, 1968 (R. 62). The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether application of the tax imposed on accumulated earnings of a corporation "availed of for the purpose of avoiding the income tax with respect

to its shareholders" requires, as the court below held, that the corporation have as its "dominant, controlling, or impelling" motive the avoidance of income tax on its stockholders, or whether it is sufficient, as the United States contends, that such a motive is one of the purposes of the accumulation.

STATUTE INVOLVED

Internal Revenue Code of 1954:

Sec. 531. IMPOSITION OF ACCUMULATED EARNINGS TAX.

In addition to other taxes imposed by this chapter, there is hereby imposed for each taxable year on the accumulated taxable income (as defined in section 535) of every corporation described in section 532, an accumulated earnings tax equal to the sum of—

(1) 27½ percent of the accumulated taxable income not in excess of $100,000, plus

(2) 38½ percent of the accumulated taxable income in excess of $100,000.

[26 U.S.C. 531]

Sec. 532. CORPORATIONS SUBJECT TO ACCUMULATED EARNINGS TAX.

(a) *General Rule.*—The accumulated earnings tax imposed by section 531 shall apply to every corporation (other than those described in subsection (b)) formed or availed of for the purpose of avoiding the income tax with respect to its shareholders or the shareholders of any other corporation, by permitting earnings and profits to accumulate instead of being divided or distributed.

* * * * *

[26 U.S.C. 532(a)]

Sec. 533. EVIDENCE OF PURPOSE TO AVOID INCOME TAX.

(a) *Unreasonable Accumulation Determinative of Purpose.*—For purposes of section 532, the fact that the earnings and profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid the income tax with respect to shareholders, unless the corporation by the preponderance of the evidence shall prove to the contrary.

[26 U.S.C. 533(a)]

STATEMENT

Respondent is a corporation engaged in the manufacture and sale of bubble gum and candy and the operation of a farm. (R. 4; see Def. Exh. 49, R. 15; Tr. 430, 467).[1] Since 1954, all of the company's outstanding stock has been owned by Don B. Wiener (R. 17).[2]

In each of the taxable years 1955 through 1961[3] respondent operated profitably. Although its undistributed earnings increased during that period from $1,021,288.58 to $1,679,315.37, the company declared no dividends (R. 11–12; Def. Exh. 49, *supra*).

The Commissioner assessed accumulated earnings taxes against respondent for the years 1960 and 1961 under Section 531 of the Internal Revenue Code of 1954 (R. 4). Respondent paid the tax and brought

---

[1] "Tr." references are to the transcript of proceedings in the district court, which are a part of the record in this Court.

[2] In 1954, the corporation redeemed the 50 per cent stock interest of a second individual (Tr. 57–59; Def. Exh. 49, *supra*).

[3] Respondent's taxable year runs from February 1 through January 31 (R. 4).

this refund suit (R. 5-6). The case was tried before a jury, where the following facts appeared:

Respondent's pre-tax net profits for 1960 and 1961 were $166,014.61 and $60,154.31, respectively. Its accumulated earnings amounted to $1,638,708.34 at the end of fiscal 1960 and $1,679,315.37 at the close of fiscal 1961. (Def. Exh. 49, *supra.*) Current assets exceeded current liabilities by a ratio of more than 8 to 1 in 1960 and 14 to 1 in 1961 (R. 9-10; Def. Exh. 48, R. 13; Tr. 428, 462, 467). Mr. Wiener, the sole stockholder, testified that the reason for accumulating the corporate earnings was to purchase stock of the company's major distributor, Tom Huston Peanut Company. But, he stated, as of 1961 there was no fixed and definite plan for such an acquisition (Tr. 81-84, 292-294).* Other reasons given for the accumulation included the possibility of a depression (Tr. 286) or war (Tr. 287), and the desire to follow, by expansion, in the "footsteps" of the Wrigley Chewing Gum Company (Tr. 149-151).

In its charge to the jury, the district court several times instructed that, for the accumulated earnings tax to apply, avoidance of tax on the corporation's shareholder had to be "the purpose" of the accumulations (R. 19, 20, 21, 22, 33, 34). The government objected on the ground that the jury would believe

* Respondent's treasurer testified that he first learned in 1963 of plans to acquire the Huston stock (Tr. 356-358). When the revenue agent examined respondent's books in 1961 and discussed the earnings accumulations with Mr. Wiener, no mention was made of a plan to purchase the stock (Tr. 470).

that tax avoidance must be the sole purpose of the accumulation, rather than one of the purposes (R. 40–41, 42, 43). The government specifically requested that the jury be instructed (R. 36):

> it is not necessary that avoidance of shareholder's tax be the sole purpose for the unreasonable accumulation of earnings; it is sufficient if it is one of the purposes for the company's accumulation policy.

The court refused this instruction. Throughout its charge, it used the statutory language only, instructing the jury that the issue was whether "the purpose" was to avoid income tax, without further explanation.

The jury, in response to interrogatories, found that during the years in issue respondent had accumulated its earnings beyond the reasonable needs of the business. It also found that respondent had not retained its earnings for "the purpose" of avoiding the income tax on its shareholder, Mr. Wiener (R. 36). Judgment was entered for the respondent on this verdict (R. 37–39), and the United States appealed.

The court of appeals reversed and remanded for a new trial, holding that under the charge "the jury might well have been led to believe that tax avoidance must be the sole purpose behind an accumulation * * *" (R. 59). In reaching this result, however, the court rejected the government's argument that the tax applies if tax avoidance is one of the purposes of the excessive accumulation, and ruled that the jury should be instructed that the tax applies only if tax

avoidance is the "dominant, controlling or impelling motive" (R. 58–60).[1]

As this limitation on the construction of the statute was in conflict with the decisions of other courts, and inconsistent with this Court's own approach in *Helvering* v. *Stock Yards Co.*, 318 U.S. 693, 699, the government sought review from this Court.

INTRODUCTION AND SUMMARY OF ARGUMENT

Under our system of income taxation, corporate earnings "are not taxed to the shareholder when they accrue to the corporation, but instead when they are passed to shareholders individually through dividends." *Commissioner* v. *Gordon*, decided May 20, 1968, Nos. 760 and 781, 1967 Term, Slip Op. 7 n. 5. Because of the disparity between corporate tax rates and the higher graduations of individual income tax rates, a corporation—particularly a closely-held one—can significantly reduce its shareholders' tax liability by accumulating its earnings beyond the amount needed to operate the business. Absent some statutory control, a controlling shareholder, by avoiding a declaration of dividends, until "a season more propitious," *United Business Corp.* v. *Commissioner*, 62 F. 2d 754, 755 (C.A. 2), would be able to postpone the income taxes on his share of earnings in excess of the corporate needs, or convert the income to capital gain through

[1] In *Shaw-Walker Co.* v. *Commissioner*, 390 F. 2d 205, 215 (C.A. 6), pending on the Commissioner's petition for a writ of certiorari, No. 95, this Term, the court below applied the same standard to a decision of the Tax Court.

sale of his stock, or even escape income taxation by retaining his interest until death.[6] See, generally, Bittker and Eustice, *Federal Income Taxation of Corporations and Shareholders*, 209 (2d ed. 1966).

To avoid these consequences, Congress, in every income tax law since the adoption of the Sixteenth Amendment, has taxed unnecessary accumulations of corporate earnings calculated to insulate shareholders from the income tax on dividends. The purpose is "to compel the company to distribute any profits not needed for the conduct of its business so that, when so distributed, individual shareholders will become liable" for the income tax on dividends. *Helvering* v. *Stock Yards Co.*, 318 U.S. 693, 699.

The present statutory provisions, Sections 531 through 537,[7] comprise Part I of Subchapter G of the Code—a group of sanctions aimed generally at "Corporations Used to Avoid Income Tax on Shareholders." These sections have three essential features. *First*, the statute imposes (Section 531) a tax in "addition to other taxes imposed by this chapter * * * on the accumulated taxable income * * * of every cor-

---

[6] A shareholder could also "borrow" the accumulated earnings from the corporation without being subject to the dividend tax. See, *e.g.*, *United Business Corp.* v. *Commissioner*, *supra*; cf. Treas. Reg. Section 1.537-2(c) (1), (2), (3).

[7] Section references hereafter are to the 1954 Code, unless otherwise indicated.

The relevant provisions of the current regulations are sections 1.531-1 through 1.537-3 of the Income Tax Regulations. As far as the present question is concerned, they appear to repeat the language of the statute, and throw no further light on its proper construction.

poration"[*] that is (Section 532(a)) "formed or availed of for the purpose of avoiding the income tax with respect to its shareholders or the shareholders of any other corporation by permitting earnings and profits to accumulate instead of being divided and distributed."

Second, there is (Section 533(a)) a rebuttable presumption that a corporation which has accumulated earnings "beyond the reasonable needs of the business" did so with "the purpose to avoid the income tax with respect to shareholders * * *." *Third*, there is a "credit" (Section 535(c)(1)) which excuses from the

---

[*] The Income Tax Law of 1913, part of the Tariff Act of 1913, Section IIA, Subdivision 2, Ch. 16, 38 Stat. 144, 166, taxed the *shareholders* on their pro rata shares of accumulated earnings of a corporation "fraudulently" availed of to prevent taxation of its shareholders. See Bittker and Eustice, *supra*, at 209–210. The word "fraudulently" was deleted in the Revenue Act of 1918, Section 220, Ch. 18, 40 Stat. 1072. See Revenue Act of 1916, § 3, 39 Stat. 758. It had made the provision "of little value, because it was necessary to its application that intended fraud on the revenue be established in each case." S. Rep. No. 617, 65th Cong., 3d Sess. 5 (1918).

The tax on the shareholders continued through 1920. Then, "doubts apparently arose as to the validity of taxing income which the taxpayers had never received, and in 1921 it was thought safer to tax the company itself * * *." *United Business Corp. v. Commissioner*, *supra*, 62 F. 2d at 756. Although the statutory language has been changed from time to time, every income tax act since 1921 has laid the tax on the corporation, rather than the shareholders, through provisions having the same substance as the present Sections 531 and 532(a). Revenue Act of 1921, § 220, 42 Stat. 247; Revenue Act of 1924, § 220, 43 Stat. 277; Revenue Act of 1926, § 220, 44 Stat. 34; Revenue Act of 1928, § 104, 45 Stat. 814; Revenue Act of 1932, § 104, 47 Stat. 195; Revenue Act of 1934, § 102, 48 Stat. 702; Revenue Act of 1936, § 102, 49 Stat. 1676; Revenue Act of 1938, § 102, 52 Stat. 483; Internal Revenue Code of 1939, § 102(a), 53 Stat. 35.

tax so much of the accumulation as is shown to have been "retained for the reasonable needs of the business".

The issue here is whether the government's requested jury instruction correctly reflected the description in Section 532(a) of the corporations which are to be taxed: those "availed of for the purpose of avoiding the income tax with respect to its shareholders". Concretely, did Congress propose, as the government urges, that a corporation shall be subject to the accumulated earnings tax whenever tax avoidance is, in the words of the proposed instruction, "one of the purposes of" a decision to accumulate rather than distribute profits unnecessary to the business? Or, as the court below ruled, is the tax limited to those situations where the finder of fact concludes that tax avoidance was the "dominant, controlling, or impelling motive" of the accumulation?

The court below, following a 1961 decision of the First Circuit, adopted the narrower construction, relying upon the use of the definite article "the" before the word "purpose" in Section 532(a) and upon cases dealing with problems of intent under unrelated income and estate tax provisions.

We contend that the results reached in the First and Sixth Circuits are not supported by the statutory language or purpose. The corporation is "availed of" for the described statutory purpose when that purpose is one of several objectives, irrespective of whether it is the dominant or controlling purpose. In short, when tax avoidance is one of the uses for which corporate earnings are unreasonably accumulated, the accumu-

lated earnings tax should apply. The simultaneous presence of other motives at most serves to reduce the tax through application of the credit provisions of Section 535(c).

The proper result here should have been clear ever since this Court's decision twenty-five years ago in *Helvering* v. *Stock Yards Co.*, 318 U.S. 693. This Court there held that a practice of accumulating earnings begun for proper purposes became subject to the tax when "continued with the additional motive of avoiding surtax" or "the purpose of avoiding surtax induced, or aided in inducing, the continuance of the practice." 318 U.S. at 699. The Second, Fifth, Eighth and Tenth Circuits have accepted the substance of the government's position, relying on the *Stock Yards* decision as well as the language and purpose of the statute.

This line of authority, moreover, represents the only result consistent with the 1938 congressional statement of purpose—that the tax applies unless there is an "absence of any purpose to avoid surtaxes upon shareholders". S. Rep. No. 1567, 75th Cong., 3d Sess. 5 (1938). The 1954 Congress, obviously aware of these authorities, recognized that a corporation's inability to justify "a minor portion of their accumulations" could "subject their entire accumulated earnings to tax". S. Rep. No. 1622, 83d Cong., 2d Sess. 72. Congress, however, did not eliminate or substantially alter the scope of the tax; it established a credit to the extent that an accumulation satisfied demonstrable business needs (Section 535(c)(1)).

The view adopted by the First and Sixth Circuits would add a novel and unintended element to the accumulated earnings tax: even the corporation with an admitted tax avoidance purpose for an accumulation could avoid the tax entirely if the trier of fact could be persuaded that the corporate managers had given at least equal weight to other considerations when deciding to accumulate rather than distribute earnings. This result, we submit, is contrary to the statutory language, the express legislative purpose, and this Court's *Stoek Yards* decision. It should be rejected here, and our proposed instruction approved.

ARGUMENT

THE ACCUMULATED EARNINGS TAX APPLIES TO EVERY UNREASONABLE ACCUMULATION OF CORPORATE EARNINGS THAT HAS TAX AVOIDANCE AS ONE OF ITS PURPOSES; SUCH PURPOSE NEED NOT BE "DOMINANT, CONTROLLING, OR IMPELLING."

A. THE LANGUAGE AND LEGISLATIVE HISTORY OF THE STATUTE DEMONSTRATE THAT CONGRESS INTENDED TO TAX ALL UNREASONABLE ACCUMULATIONS HAVING A TAX-AVOIDANCE PURPOSE

1. Sections 531 and 532(a) impose the accumulated earnings tax upon "every corporation" which has been "availed of for the purpose of avoiding the income tax with respect to its shareholders * * *." The phrase to be construed is "availed of for the purpose". The words "availed of" mean "used". The inquiry thus is the reach of a statute that depends for its application on "the purpose" for which a corporation is "availed of" or "used".

Rarely has a corporation but a single purpose for particular conduct. Any given corporation will be "availed of" for a variety of "purposes". Tax avoidance seldom will appear as the sole or even the most readily discernible motive, whether the focus of attention be an accumulation of earnings or any other corporate act. Accumulated-earnings cases invariably involve a surplus, usually held in cash or other quick or investment assets, which has a broad variety of potential uses and has been accumulated by a series of acts. Almost certainly, the purpose of tax avoidance, when present, will arguably be intermixed with other objectives. Attempts to apply the accumulated earnings tax are particularly likely to invoke assertions of multiple corporate purposes. The potential variations—of degree as well as kind—are endless.

The statutory language, however, carries no suggestion that Congress intended application of the tax to depend on the relative importance of tax avoidance within the generality of corporate purposes. The statute does not require that the corporation be "predominantly availed of" for tax avoidance, or that it have a "controlling" or "impelling" tax avoidance "purpose" for accumulating its earnings. The phrase "availed of" does not imply that the described purpose—tax avoidance—must have singular importance in the scheme of corporate operation. Nor can such a restriction be found anywhere in the relevant provisions. This is in significant contrast to other parts of the Internal Revenue Code, also addressed to possible abuses of the corporate form, which require for their application that tax avoidance be the "principal

purpose" (Sections 269(a), 357(b)(1)) or that the corporation be "used principally" for that aim (Section 355 (a)(1)(B)).

The choice of the phrase "availed of," without any such qualification, fortifies the obvious conclusion that imposition of the tax does not depend on whether tax avoidance has primacy over other corporate purposes. Once a corporation is, in the language of the subchapter title, "used to avoid income tax on shareholders," it has engaged in the conduct described in Part I of the Subchapter—"improperly accumulating surplus." Inquiry into other motives underlying the accumulation may then be proper to determine whether part of the accumulation is excused from tax under the credit provisions of Section 535(c). But that inquiry performs no broader service; nothing in the statutory words allows a full escape from the tax on the ground that the tax avoidance purpose was not dominant in the decision to accumulate rather than distribute earnings.

2. The court below, in reading the statute more narrowly, adopted the rationale of the First Circuit in *Young Motor Co.* v. *Commissioner*, 281 F. 2d 488, 491:*

> The statute does not say "a" purpose, but "the" purpose. The issue is not what are the necessary, and to that extent contemplated consequences of the accumulation, but what was the primary or dominant purpose which led to the decision [to accumulate]. Cf. *Commissioner of*

* See, also, *Appollo Indus., Inc.* v. *Commissioner*, 358 F. 2d 867 (C.A. 1)

Internal Revenue v. *Duberstein*, 1960, 363 U.S. 278 * * *.

The conclusion is premised on one word of the statute—the definite article "the" appearing before the word "purpose". But this analysis not only gives an unduly narrow effect to the simple word "the," but it overlooks other essential language. The definife article appears not in isolation, but in the phrase "availed of for the purpose * * *." The total phrase is by itself indefinite, and, as a matter of ordinary English usage, not restricted by the "the" within it. Any reading of the phrase as requiring that tax avoidance be the "dominant, controlling, or impelling motive" should rest on language qualifying the words "availed of". There is, of course, no such modifier in Section 532(a), or anywhere else in the accumulated earnings provisions of the Code.

No other result may fairly be inferred from *Duberstein* or the three estate tax cases upon which the court below relied, *United States* v. *Wells*, 283 U.S. 102; *City Bank Farmers Trust Co.* v. *McGowan*, 323 U.S. 594; and *Allen* v. *Trust Co. of Ga.*, 326 U.S. 630. The question in *Duberstein* was whether a certain transfer was a "gift," which Section 22(b)(3) of the 1939 Code (now Section 102(b)) excludes from gross income—a problem which has no connection with the phraseology or purposes of Section 532(a).

Section 2035(a)—the provision involved in the cited estate tax cases—speaks of transfers "made * * * in contemplation of * * * death"—language that suggests a need to find a principal controlling thought on the part of the transferor: "the motive * * * must

be of the sort which leads to testamentary disposition." *United States* v. *Wells*, *supra*, 283 U.S. at 117.

Moreover, the above cases represent two instances in the wide range of human affairs with which the tax code must deal. Each situation presents its own definitional problems, each encrusted with its own historical development. Thus, in *Duberstein*, this Court was unwilling to draw on precedents based on other provisions of the tax code. "Analogies and inferences drawn from other revenue provisions, such as the estate and gift taxes, are dubious. See *Lockard* v. *Commissioner*, 166 F. 2d 409." *Commissioner* v. *Duberstein*, *supra*, 363 U.S. at 284. This is particularly true here, where the Sixth Circuit has attempted to engraft on Section 532(a)—a provision dealing with an income tax problem applicable only to corporations—an agglomeration of two lines of precedent, neither relevant to the other and each from a context entirely alien to the accumulated earnings tax.[10]

---

[10] Any analogy to other provisions of the Code must be based on the fact that the accumulated earnings impost is not the usual income tax, but is a regulatory, "penalty" provision, S. Rep. No. 1622, 83d Cong., 2d Sess. 68 (1954). *Helvering* v. *National Grocery Co.*, 304 U.S. 282, 288–289, 290; see, also *Helvering* v. *Mitchell*, 303 U.S. 391, 405 n. 15. Thus if there is any relevance in cases dealing with provisions outside Subchapter G, it lies in cases such as *Spies* v. *United States*, 317 U.S. 492, 499, where, in the same term as the *Stock Yards* decision, *supra*, this Court decided that *criminal* fraud penalties apply "[i]f the tax-evasion motive plays any part in such conduct, [the likely effect of which would be to mislead or to conceal] * * * even though the conduct may also serve other purposes such as concealment of other crime." No more can be required here, in dealing with a civil provision that Congress—in 1918—decided should be applied more readily than one based on fraud. See note 8, *supra*.

3. Congress itself has made clear that its use of the definite article does not have the significance attached to it by the court below. Until 1938, the predecessor of the presumption in Section 533(a) made an unreasonable accumulation "*prima facie* evidence of *a* purpose to avoid surtax" upon shareholders, although the taxing provision then, as now, was addressed to corporations "availed of for *the* purpose * * *". *E.g.*, Revenue Act of 1932, § 104(a), (b), 47 Stat. 169, 195. (Emphasis supplied.) The definite article before the word "purpose" could hardly have been intended to control application of the statute when the companion presumption used the indefinite "a" at the parallel point.

When Congress, in the Revenue Act of 1938, Section 102(c), Ch. 289, 52 Stat. 447, 463, adopted the current wording of the presumption—that an unreasonable accumulation of earnings shall be "*determinative* of the purpose to avoid [income] tax" (emphasis supplied)—it made very clear that it was increasing the taxpayer's burden of proof, and not, as the Sixth Circuit would reason from the insertion of a definite article, creating an additional barrier to imposition of the tax. The legislative purpose was to replace the mere "prima facie" presumption with a "determinative" one to combat tax avoidance that had persisted "to a considerable extent" under pre-1938 law. S. Rep. No. 1567, 75th Cong., 3d Sess. 4 (1938). By making the presumption "determinative," Congress shifted to the taxpayer not only the burden of going forward, as under prior law, but also the burden of proof, see *id.* at 16. The Senate Finance Committee described

the change as "requiring the taxpayer by a clear preponderance of the evidence to prove the absence of *any* purpose to avoid surtaxes upon shareholders after it has been determined that the earnings and profits have been unreasonably accumulated." *Id.* at 5 (emphasis supplied); see, also, H. Rep. No. 855, 76th Cong., 1st Sess. 6 (1939).

Congress, when it adopted the 1954 Code, recognized that the accumulated earnings provisions had been interpreted in the manner indicated in the 1938 legislative history—commenting that corporations "feared" that an inability to justify "a minor portion of their accumulations * * * will subject their entire accumulated earnings to tax." S. Rep. No. 1622, 83d Cong., 2d Sess. 72 (1954). Congress, however, rejected[11] requests for repeal of the tax.[12] Instead, it dealt with the seeming inequity of taxing in its entirety an ac-

[11] Congress thought it "necessary to retain the penalty tax on unreasonable accumulations as a safeguard against tax avoidance". H. Rep. No. 1337, 83d Cong., 2d Sess. 52 (1954); S. Rep. No. 1622, *supra* at 68.

[12] The present presumption requires the taxpayer with an unreasonable accumulation to prove an absence of the tax avoidance purpose by "the preponderance of the evidence" (Section 533(a)). Prior law spoke of a "clear preponderance". *E.g.*, Section 102(c) of the Internal Revenue Code of 1939. No change in standard seems to have been intended. Thus Congress commented that a taxpayer "must bear the burden of proof as under existing law" unless it took advantage of a procedure that the 1954 Code created for shifting the burden to the government in Tax Court cases by serving upon the Commissioner (Section 534(c)) "a statement of the grounds (together with facts sufficient to show the basis thereof) on which the taxpayer relies to establish that all or any part of the earnings and profits have not been permitted to accumulate beyond the reasonable needs of the business". H. Rep. No. 1337, *supra* at 52; S. Rep. No. 1622, *supra* at 71.

cumulation partially motivated by proper purposes by adopting the "accumulated earnings credit" of Section 535(c)(1), which provides that the tax shall not apply to "such part of the earnings and profits * * * as are retained for the reasonable needs of the business * * *."[12]

Thus, the Congressional plan is to make the tax inapplicable, even if there is a tax avoidance motive, to that part of the accumulation that is reasonable, but only to that extent. If the corporation has a variety of motives for the accumulation, it does not matter which predominates. Congress has instead provided for elimination of the tax to the extent that demonstrable business needs justify the accumulation. But any portion that cannot be justified—even the "minor portion" referred to in S. Rep. 1622, *supra* at 72—is to be taxed under Section 531.

B. THE STATUTORY PURPOSE OF COMPELLING DISTRIBUTION OF PROFITS NOT NEEDED FOR THE CONDUCT OF THE BUSINESS REQUIRES APPLICATION OF THE ACCUMULATED EARNINGS TAX UNLESS THERE IS A COMPLETE ABSENCE OF TAX AVOIDANCE MOTIVE FOR AN UNREASONABLE ACCUMULATION

The target of the accumulated earnings tax is described in the final words of Section 532(a)—tax

[12] Section 535(c)(2) sets the minimum exclusion at "the amount by which $100,000 exceeds the accumulated earnings and profits of the corporation at the close of the preceding taxable year." By this provision a corporation is allowed to accumulate over its life $100,000 free of the accumulated earnings tax. In practical effect, small businesses are excepted from the tax in most instances. See H. Rep. No. 1337, *supra* at 53–54; S. Rep. No. 1622, *supra* at 71–72.

avoidance "by permitting earnings and profits to accumulate instead of being divided or distributed". The tax is specifically designed to deter conduct—"the manipulation of dividends to avoid taxes," *United Business Corp.* v. *Commissioner, supra,* 62 F. 2d at 756; the method is "to compel the company to distribute any profits not needed for the conduct of its business so that, when so distributed, individual shareholders will become liable" for income taxes on their dividends. *Helvering* v. *Stock Yards Co., supra,* 318 U.S. at 699.

The ultimate fact that brings the accumulated earnings tax into play is the subjective tax-avoidance motive of those in command of corporate affairs. But such questions of intent are not satisfactorily tried on the basis of the self-serving, after-the-fact, trial testimony of the corporate managers. They are better determined on the basis of the contemporaneous words and deeds that more accurately reflect the true motives. The evidence of these objectively ascertainable facts, however, is largely in the control of those who at trial assert the propriety of their earlier purposes. In consequence, as Judge Learned Hand explained in holding the 1921 accumulated earnings tax valid, "A statute which stands on the footing of the participants' state of mind may need the support of presumption, indeed be practically unenforceable without it * * *." *United Business Corp.* v. *Commissioner, supra,* 62 F. 2d at 755; see, also, *Barrow Manufacturing Co.* v. *Commissioner,* 294 F. 2d 79, 82 (C.A. 5), certiorari denied, 369 U.S. 817. This is the reason for the presumption in Section 533(a), which makes

an unreasonable accumulation determinative on the issue of tax-avoidance purpose in the absence of a contrary showing. The idea is to "make the taxpayer show his hand"—"to compel the taxpayer to disclose the facts". *United Business Corp.* v. *Commissioner, supra*, 62 F. 2d at 755, 756.

Through the presumption, Congress intended that a corporation's claims of proper motive be tested primarily against what was contemporaneously said and done. Thus, the Senate Finance Committee said, in discussing a 1954 amendment that allowed accumulations of amounts intended for future use—*i.e.* "the reasonably anticipated needs of the business" (Section 537), (S. Rep. 1622, *supra* at 69):

> It is contemplated that this amendment will cover the case where the taxpayer has specific and definite plans for acquisition of buildings or equipment for use in the business. It would not apply where the future plans are vague and indefinite, or where execution of the plans is postponed indefinitely.

The practical workings of the presumption mirror this statutory purpose. Once it is shown, as Section 533(a) requires, that earnings have accumulated "beyond the reasonable needs of the business," the taxpayer must, "by a preponderance of the evidence" negative "the purpose to avoid the income tax with respect to shareholders". Of necessity, there is at this stage no credible objective evidence to reinforce claims of proper motives; otherwise the presumption would not have come into play. If, nevertheless, the taxpayer's witnesses are convincing in their testimony of subjective motives other than tax avoidance,

the trier of facts can find for the corporation, and no accumulated earnings tax will be imposed. The trier of the facts may, however, reject such testimony as impeached by the objective evidence of the witnesses' earlier words and deeds." If that happens, by definition there was no reason for the failure to distribute, and the tax must be applied to implement the Congressional purpose of compelling dividends when there are "profits not needed for the conduct of the business" (318 U.S. at 699).

The government's proposed rule is necessary if the courts are to effectuate this design. A finding that tax avoidance is "one" of the purposes of an accumulation "beyond the reasonable needs of the business" is equivalent to a failure to show "the absence of any" such purpose. This is precisely the circumstance when Congress intended the tax to apply, see pp. 16–17, *supra*. Thus, if the corporation fails to demonstrate need for the accumulation, the tax is applied, except in those unusual cases where the trier of facts is persuaded that tax avoidance played no part in inducing the unnecessary accumulation. Cf. *Heyward & Co.* v. *United States*, 1966–2 Tax Cases ¶ 9667 (W.D.N.C., decided Sept. 1, 1966).

---

[14] For example, see *Dickman Lumber Co.* v. *United States*, 355 F. 2d 670 (C.A. 9) (claimed need for reserves to meet competition, fluctuation of business; planned modernization of plant); *Dixie, Inc.* v. *Commissioner*, 277 F. 2d 526, 528 (C.A. 2), certiorari denied, 364 U.S. 827 (no specific plan for remodeling rental premises); *Fenco, Inc.* v. *United States*, 234 F. Supp. 317, 325 (D. Md.), affirmed *per curiam*, 348 F. 2d 456 (C.A. 4) (vague plans for building). See, also, Treas. Reg. Section 1.537–1(b)(1); S. Rep. No. 1622, 83d Cong., 2d Sess., pp. 69–70 (1954).

The First and Sixth Circuits would call for a quite different approach. The inquiry could not end upon a finding that accumulations exceeded the needs of the business and that a tax avoidance motive was present. A further inquiry would be needed to determine the relative importance of that motive among the various reasons ascribed for the accumulation. Motive is itself hard enough to determine. Assessment of the relative importance and priority of several motives is even more difficult. Generally no evidence would be available other than the trial testimony of corporate managers that in their minds any thought of tax avoidance was no more important than (or was subordinated to) other objectives. There will rarely be objective evidence by which such claims may be tested.[15] Yet, the trier of the facts would be called upon to determine what motive was "dominant, controlling or impelling".

[15] By way of contrast, in the "gift in contemplation of death" cases on which the Sixth Circuit relied, see pp. 14–15 *supra*, the alleged primacy of the tax avoidance motive may be weighed against such other motives as normally motivate inter vivos gifts by considering such observable facts as: the decedent's relationship to the donee, the donor's statements at the time of the transfer, the donee's needs, the donor's age and knowledge of his health, and the date of drafting and the design of the donor's will. See *United States* v. *Wells*, *supra*, 283 U.S. at 118–119. Moreover, the donor will not be available and therefore the estate cannot rest on self-serving uncorroborated testimony. Even so, it has been said: "If the subjective test [of Section 2035(a)] is not an active inducement to fraud and perjury, it at least encourages what Randolph Paul euphemistically refers to as 'carefully assembled evidence' that gifts were not in contemplation of death." Lowndes and Kramer, *Federal Estate and Gift Taxes* 71 (1956), citing 1 Paul, *Federal Estate & Gift Taxation* 279 (1949).

Here, for example, respondent disclaimed any tax-avoidance purposes and contended that the earnings were accumulated with a view to acquiring a distributor and expanding to the point of competing with the Wrigley Company (although no definite plans for such corporate action had evolved), and because of fears of war or depression (Tr. 81–84, 149–151, 286–287, 292–294, 356–358, 470). The jury found that respondent's accumulation had been "beyond the reasonable or reasonably anticipated needs of its business" (R. 37)—*i.e.* that the objectively ascertainable facts did not justify the accumulation (see R. 28–29). But at the same time the jury found that "avoiding the income tax on its stockholder, Don Wiener" was not "the purpose" (R. 37)—*i.e.* tax avoidance was not the "sole" purpose (see R. 59)—of the accumulation.

It follows that respondent had available earnings that were not necessary to the conduct of the business and could have been distributed. If a corporation such as respondent can escape the penalty tax of Section 531 simply because its managers considered other factors as important as diminishing the tax burden of a sole shareholder such as Mr. Wiener, there is no significant compulsion to distribute unneeded earnings. The taxpayer may rest on unchallengeable and entirely unprovable assertions of state of mind, and no longer need "disclose the facts" (62 F. 2d at 756) that corroborate his assertions. "The utility of the badly needed presumption arising from the accumulation of earnings beyond the reasonable needs of the business is well nigh destroyed if that presumption in turn is saddled with the requirement of proof of 'the primary

or dominant purpose' of the accumulation." *Barrow Manufacturing Co. v. Commissioner, supra,* 294 F. 2d at 82.

C. A LONG LINE OF JUDICIAL DECISIONS SUPPORTS THE GOVERNMENT'S POSITION

It is of no small moment that for some forty-seven years following the first accumulated earnings tax provision there was no judicial holding that imposition of the accumulated earnings tax depended on a showing that there was a *dominant* motive to avoid taxes. Every indication save one was to the contrary, and that sole exception was a decision which this Court reversed.

Thus in 1938, the Board of Tax Appeals interpreted the 1932 predecessor of the presumption now in Section 533(a) as requiring a holding company [16] to establish "its purpose to be wholly other than that of preventing surtax upon its shareholders—not only that there was another purpose, but that there was a complete absence of the disapproved purpose. Obviously a holding or investment corporation may be formed or availed of for several purposes, but it cannot escape this tax unless it proves that it had no purpose to enable the escape of surtax." *R. L. Blaffer & Co.*, 37 B.T.A. 851, 856, affirmed, 103 F. 2d 487 (C.A. 5), certiorari denied, 308 U.S. 576.

Thereafter, the First Circuit, in reversing another decision of the Board of Tax Appeals, commented that

[16] In 1938, and now (Section 533(b)), the statute presumption provides that the fact that a "corporation is a mere holding or investment company shall be prima facie evidence of the purpose to avoid * * * tax * * *."

Blaffer was "[p]erhaps * * * too strong a statement; but at least it is clear that § 104 would apply if in the totality of reasons which induced the continuing of the accumulation the forbidden motive of surtax avoidance played a substantial part." *Chicago Stock Yards Co.* v. *Commissioner*, 129 F. 2d 937, 948, reversing 41 B.T.A. 590.

This Court in turn reversed the court of appeals, holding that the Board of Tax Appeals had properly taxed an unreasonable accumulation. *Helvering* v. *Stock Yards Co., supra.* In considering the point at which a corporation "formed" before the Sixteenth Amendment became "availed of" for avoiding the tax on shareholders, the Court reasoned (318 U.S. at 699):

> A corporate practice adopted for mere convenience or other reasons, and without tax significance when adopted, may have been continued with the *additional* motive of avoiding surtax on the stockholders. The Board's conclusion may justifiably have been reached in the view that, whatever the motive when the practice of accumulation was adopted, the purpose of avoiding surtax *induced, or aided in inducing, the continuance of the practice.* [Emphasis added.]

This rationale says far more than the Sixth Circuit's view (R. 58) that this Court implied no more than "that the purpose to avoid income tax need not be the sole purpose behind an accumulation in order for the additional tax to be imposed". This Court said nothing to indicate that the corporate purposes had to become so changed that tax avoidance overcame all others in importance. It was necessary only that

there be an "additional motive of avoiding" tax. No need was discerned to inquire whether tax avoidance was the "dominant, controlling, or impelling" cause of the accumulation. It sufficed that tax avoidance "aided in inducing" the accumulation, as would be the case if, in the terms of our proposed rule, tax avoidance is "one of the purposes" of an unreasonable accumulation.

For the next seventeen years—until the First Circuit's decision in *Young Motor Co.* v. *Commissioner*, *supra*—the courts continued to agree with the government's position. In explicit reliance on *Stock Yards*, the Second Circuit refused to "subscribe to the view that the prevention of the imposition of surtaxes must have been shown to have been the dominant factor behind the accumulations." *Trico Products Corp.* v. *Commissioner*, 137 F. 2d 424, 426, certiorari denied, 320 U.S. 799; see, also, *United States* v. *Duke Laboratories, Inc.*, 337 F. 2d 280, 283 (C.A. 2) ("The problem for the jury was to determine from all the evidence whether there was any intent in making the accumulations to avoid taxes"). In like manner the Fifth Circuit expressly refused to find error in the Tax Court's failure to find that tax avoidance "was the primary or dominant purpose". *Barrow Manufacturing Co.* v. *Commissioner*, *supra*. The Tenth Circuit, followed by the Eighth, read the statute as requiring only that the proscribed purpose be one of the determining purposes of the accumulation. *World Pub. Co.* v. *United States*, 169 F. 2d 186, 189 (C.A. 10), certiorari denied, 335 U.S. 911; *Kerr-Cochran, Inc.* v. *Commissioner*, 253 F. 2d 121, 123 (C.A. 8).

The government's proposed instruction was fully in keeping with these authorities. Since, as emphasized above, the line of decisions upon which we rely is consistent with the statute and its purposes and has met with the continuing approval of Congress, we submit that there can be no sound reason for a departure.[17]

CONCLUSION

The judgment of the court of appeals should be appropriately modified and the cause remanded to the district court for a new trial, with directions to grant the government's requested instruction.

Respectfully submitted.

ERWIN N. GRISWOLD,
Solicitor General.
MITCHELL ROGOVIN,
Assistant Attorney General.
HARRIS WEINSTEIN,
Assistant to the Solicitor General.
RICHARD C. PUGH,
MARTIN T. GOLDBLUM,
Attorneys.

JULY 1968.

[17] Compare *Joint Indus. Bd.* v. *United States*, No. 616, Oct. Term, 1967, decided May 20, 1968; *Missouri* v. *Ross*, 299 U.S. 72, 75; *Canada Packers* v. *A.T. & S.F.R. Co.*, 385 U.S. 182, 184; *Reed* v. *The Yaka*, 373 U.S. 410, 414; *Francis* v. *Southern Pacific Co.*, 333 U.S. 445, 449–450.